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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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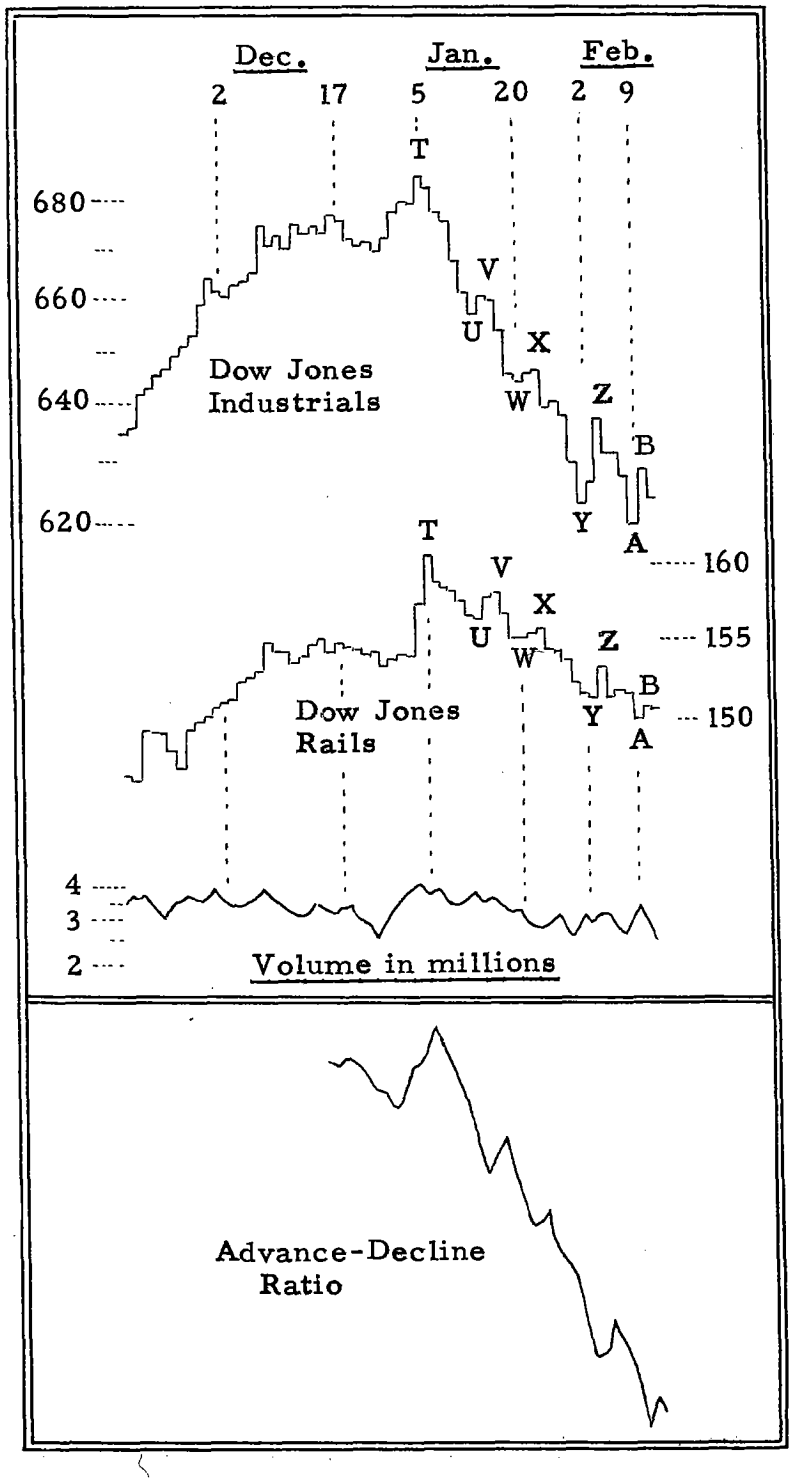
PRICE MOVEMENTS. Market students, whether bulls or bears, were treated to a few additional grey hairs last week. Price swings of 5 to 9 points a day were the rule, rather than the exception. Looking at the broad picture, the two Averages have now plotted a series of descending zig-zags from T (see chart), each high forming under the preceding high and each successive low under the preceding low. Until this pattern is broken, the secondary trend must be classified as down. As has been the case over the last month, volume indications have been deceptive. Volume has not tended to expand on the sharp little rallies (points V, X, Z, B), but neither has volume been considerable on the downside.



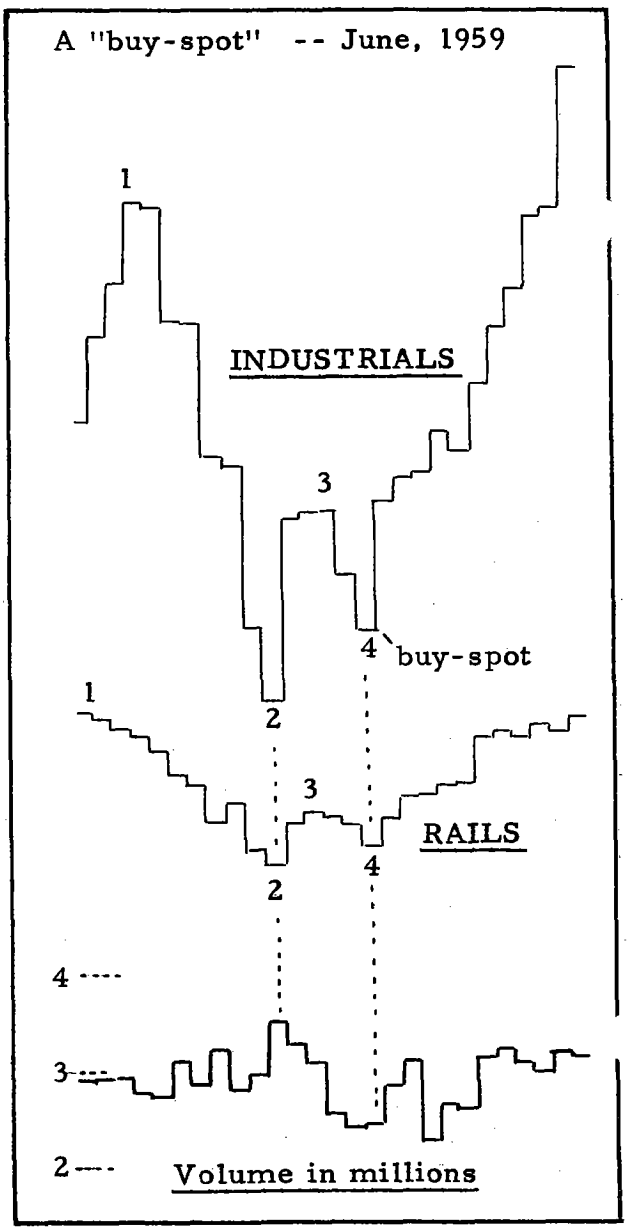
On February 8th both Averages violated their preceding decline lows at Y to the accompaniment of 3.35 million shares, the heaviest volume in 18 trading days. This move took Industrials under their 616.45 bear signal point on an intra-day basis, but a rally in the afternoon served to bring Industrials back above the critical point. Since intra-day readings are meaningless to Dow Theorists, the temporary penetration held no forecasting value. Moreover, Rails have held above their critical point of 146.65 so that even if Industrials had closed under 616.45, no bearish conclusions could have been drawn (penetrations must be confirmed by both Averages.) It is interesting to observe that Rails have recently reversed their standing and are showing up as the weaker Average. The carriers are now quite sluggish on the rallies while on declines they tend to lose as much in percentages as the Industrials.

A subscriber writes: "What would be the first signs of a possible extended rally from this area?" I have been somewhat hesitant in answering this question because

of the consistently heavy odd-lot buying balances which have accompanied the whole decline since point T. The odd-lot figures suggest a good deal of technical weakness (as do many other technical indicators -- see Letter 91), all of which casts doubt on the chances of a rally's progressing very far from this area. However, if both Averages hold persistently above their bear signal points (Industrials 616.45, Rails 146.65) we cannot discount the possibility of a correction which could retrace at least 1/3 to 2/3 of the losses since T.

If such a turn is in the cards, I suggest that traders who are so inclined buy only on the implications of a classic Dow 'buy-spot." I have shown a typical buy-spot on the accompanying chart. The formation which is illustrated actually occurred in June, 1959, and those of us who bought then did quite well with our purchases. The technical picture appeared more hopeful at that time, however.

Following the peak at #1 (see chart), prices dropped sharply to #2 as heavy volume appeared. Note that there was nothing at #2 to suggest buying! The little rally from #2 to #3 came on decreasing volume, but at #4, one or both (in this case both) Averages held above the #2 points to the accompaniment of extremely light volume. This low volume on the second approach to the preceding decline lows (#2) suggested the classic Dow buy-spot. When both Averages subsequently rallied back over #3 the correctness of the buy-spot was verified. But most important -- purchases made at #4 could have been sold immediately had both Averages turned down and closed under the #2 points. This is the "safety valve" in the Dow spot-buy mechanism, and it should never be forgotten. Since the #2 points are just under the #4 points, losses would have been quite small if they had to be taken on a breaking of the #2 points.



Normally in bull markets the Averages plot a dragging "sideways" movement following a reaction. The secondary trend can usually be considered to have turned up when a series of two or more ascending zig-zag structures appears from such a base. In bear markets downswings are apt to terminate with no warning, to be followed by violent reactions (upward). Heavy volume may or may not appear at the bottom of a bear market decline, but in bull markets the great majority of secondary reactions end on relatively heavy trading.

Should a rally now take place, the first important points to watch are at Z (Industrials 636.92, Rails 153.15). A failure of one or both Averages to better these nearby peaks would suggest that the situation is still highly dangerous. Volume diminishing as the Z points are approached would also be a sign of weakness.

Personally, unless I saw something resembling the typical "sideways" structure which normally comes after a bull market reaction, I would not be inclined to buy here. Another "straw in the wind" which has kept me cautious -- following the little peak at point Z, we saw two days of dullness as prices receded. This suggested a buy-spot, but the Averages immediately plunged through the preceding Y points

on increasing volume. This was very unusual action, and although I did not buy following Z, the deceptiveness of the movement left a "bad taste in my mouth."

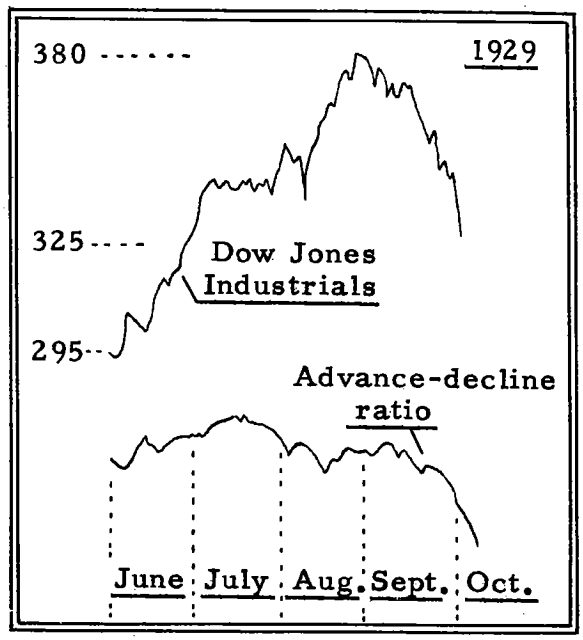
ADVANCE-DECLINE RATIO. I have received so much correspondence on the advance-decline ratio (Letter 90) that I have decided to write a bit more about this "breadth of the market" indicator. The A-D ratio is derived as follows: subtract the total of the number of stocks that decline each day from the total of those that advance.(or vice versa if more stocks declined than advanced). The resultant figure is divided by the total of issues traded on that day. This ratio is then added (if more stocks advanced) or subtracted (if more stocks declined) to the previous day's figure. You may start a chart with any arbitrary number -- such as 50. For example: January 1st -- advances 300, declines 700, unchanged 200, total issues traded 1200; declines minus advances equals 400; 400 divided by 1200 is 3.33. Subtract 3.33 from the previous total which we will arbitrarily call 50, and this gives you 46.66 for your January 1 entry. Repeat this process on each succeeding day.

The A-D ratio provides an excellent indication of the direction of the total market as compared to the movements of the "blue-chip" D-J Industrials. I have found the ratio to be a useful technical aid, and it is most useful when it is at variance with the Averages. For instance, in late 1957 the ratio turned sharply up while the D-J Industrials were moving sideways. This suggested the subsequent strong advance in the Averages. Conversely, at tops the ratio often plots a downward path while the Dow either holds or actually rallies against the ratio. When such divergence appears it is a signal for caution, and more often than not the Dow Stocks will retreat in the face of steady erosion in the A-D ratio.

In 1937 the ratio turned down in March and continued down. Despite this the D-J Industrials hit a peak, reacted, then advanced to within 4 points of their March high. In September, 1937, the Dow followed the ratio and collapsed. In 1929 (see enclosed chart) the ratio hit a high in July -- then turned down while the Dow Stocks surged to their historic September 3 high. After September 3 came the deluge. More recently (see Letter 90) the ratio hit a high in March, 1959. Since then it has been steadily eroding despite the July, 1959, and January, 1960, peaks recorded by the D-J Industrials. This week (see chart on page 1) the A-D ratio touched a new 1959-60 low.

QUESTION: What if both Averages dropped below the bear signal points during the day, then rallied to close above those points? Would this be a bear signal?

ANSWER: Under the Dow Theory, only closing prices considered. Until both Averages close under their bear points, we cannot consider the primary trend as down. The reason for ignoring intra-day prices is that, theoretically, floor traders can manipulate prices during the course of a day's trading. But since the large majority of floor traders "clean out" before closing time, we are concerned with prices as they are recorded on the final "run-off."



QUESTION: I have recalculated the D-J Industrials on the basis of the figures prior to the recent changes in that Average. On the old basis, Industrials gave half a bear signal. Is this significant?

ANSWER: The recent September Industrial lows of 616.45 were established with the new changes, so why recalculate the senior Average on the pre-changed basis? Moreover, even if Industrials did give half a

bear signal, Rails are required to confirm the move.

QUESTION: The New York Times and the Herald Tribune (N.Y.) Averages have both violated their lows for all of 1959. Is this suggestive of a bear signal in the Dow?

ANSWER: I have watched the leading newspaper averages along with the D-J Averages for many years. Inferences drawn from composite averages such as the New York Times or Tribune Averages (which include Industrials and Rails together) are often misleading. The Dow-Jones Averages have been tested over many years, and they are followed throughout the world; Dow Theorists are concerned only with the movements of the Dow-Jones Averages.

QUESTION: In November the Rails violated their September bear signal point of 150.28. You said at that time that Rails gave half a bear signal. Subsequently you classified the November Rail low of 146.65 as the Rail bear signal point, why?

ANSWER: Following the September lows, both Averages rallied, and a period of spectacular divergence ensued. During this confusion Rails recorded a new low of 146.65. I reclassified the entire July-November move in Rails as one continuing reaction which touched bottom at 146.65. Because of the full upward retracement (in both duration and extent) which came after this final Rail low, I have designated 146.65 as the Rail bear signal point; the 616.45 Industrial point, of course, still stands as the bear signal level on the senior Average.

QUESTION: Two leading "point-and-figure" chartists wrote articles last month, one in Forbes and one in Financial World. They said that if the Dow-Jones Industrial Average touched 680 it would go to 740, what happened?

ANSWER: These gentlemen have not learned that the movements of one Average, unconfirmed by the other, have no forecasting value. Point-and-Figure (or any other analysis), when it deals with one Average alone, is a completely useless study.

NOTE: Subscribers may be interested in my article which appeared in last week's Barron's (February 8th issue). The article surveyed the current position of the market and covered some of the characteristics of primary bear markets.

(Written February 11 - 2 P.M.)

FOR ADDITIONAL STUDIES Historical chart book of the Drew "Odd Lot" Studies ($20.00), put out by Drew Odd Lot Studies, 53 State Street, Boston, Mass.

Historical charts of the Dow Jones Averages (Daily price movements and volume, 1896 to present), from Traders Research, Inc. Suite 375, Arcade Building, St. Louis 1, Mo.

"Technical Analysis of Stock Trends" by Edwards & Magee, (carried by most large book retailers).